# COOLABAH CAPITAL INVESTMENTS™

THE INTELLECTUAL EDGE: MAKING EVERY BASIS POINT COUNT

Fund: **Smarter Money Long-Short Credit Fund - Direct Investor Class**

Strategy: **Alternatives/Unconstrained Fixed-Income**

Return (since Sep. 2017): **4.13% pa gross (2.32% pa net)**

Net return volatility (since Sep. 2017): **3.46% pa**

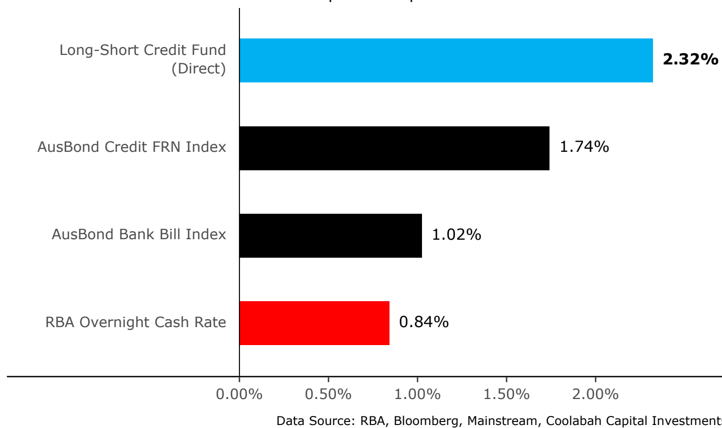
Atchison/Australia Ratings: **Recommended/Very Strong**

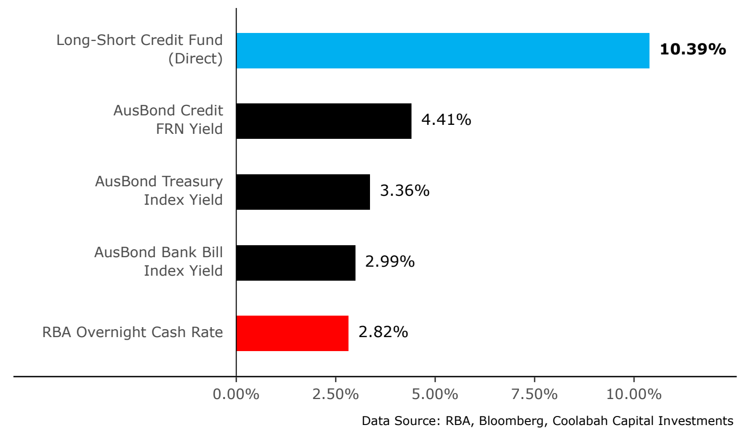
## November 2022

**Objective:** An absolute return fixed-income strategy focused on exploiting long and short mispricings in credit markets that targets high-yield like returns above the Reserve Bank of Australia (RBA) cash rate plus 4% to 6% p.a. over rolling 3 year periods with volatility of less than 5% p.a. after Management Fees, Administration Fees and Performance Fees.

**Strategy:** We add value via active asset-selection using a range of valuation models with the aim of delivering superior risk-adjusted returns, or alpha, to traditional hedge funds. We primarily invest in senior and subordinated debt securities, hybrids and derivatives issued by Australian entities domestically, although we can invest in these securities when they are issued overseas, or by overseas entities (into Australia or offshore). The Fund can use gearing and targets holding the majority of its portfolio in investment-grade securities. It is managed by Coolabah Capital Investments.

| Period Ending 2022-11-30 | Gross Return (Direct) | Net Return (Direct)† | RBA Cash Rate | Gross Excess Return‡ | Net Excess Return (Direct)†‡ |
|---|---|---|---|---|---|
| 1 month | 3.13% | 3.05% | 0.23% | 2.90% | 2.82% |
| 3 months | -1.20% | -1.45% | 0.62% | -1.82% | -2.07% |
| 6 months | -2.82% | -3.30% | 0.93% | -3.75% | -4.23% |
| 1 year | -3.30% | -4.27% | 0.98% | -4.28% | -5.25% |
| 2 years pa | -0.28% | -1.57% | 0.50% | -0.78% | -2.07% |
| 3 years pa | 2.36% | 0.69% | 0.44% | 1.93% | 0.25% |
| 4 years pa | 4.05% | 2.13% | 0.64% | 3.42% | 1.50% |
| 5 years pa | 3.93% | 2.14% | 0.81% | 3.13% | 1.33% |
| **Inception pa Sep. 2017** | **4.13%** | **2.32%** | **0.84%** | **3.29%** | **1.48%** |



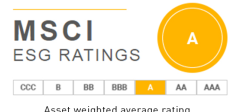

† Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. ‡ The Excess Return columns represent the gross and net return above the RBA cash rate.

**Disclaimer:** Past performance does not assure future returns. Returns are shown net of all Management and Performance fees unless otherwise stated. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed. To understand Fund's risks better, please refer to the Product Disclosure Statement available at Coolabah Capital Investments' website.

*Note: all portfolio statistics other than running yield reported on gross levered value*

| | | | |
|---|---|---|---|
| Net Monthly Returns > RBA Overnight Cash Rate | 71% | Av. Interest Rate (Gross Running Yield) | 5.07% |
| Gross Portfolio Weight to Cash Securities | 4.4% | Modified Interest Rate Duration | < 0.1 years |
| Gross Portfolio Weight to Bonds | 96.3% | Gearing Permitted? | Yes |
| Av. Portfolio Credit Rating | AA- | 1 Year Av. Gross Portfolio Weight to Cash | 8.7% |
| Portfolio MSCI ESG Rating | A | Gross Portfolio Weight to AT1 Hybrids | 1.3% |
| No. Cash Securities | 18 | Gross Cash Securities + RBA Repo-Eligible Debt | 75.0% |
| No. Notes and Bonds | 124 | Net Annual Volatility (since incep.) | 3.46% |

**Awards:** FE Alpha Manager 2019: Christopher Joye; **Ratings:** Lonsec available to advisers; Recommended (Atchison); 'Superior More Complex' (Foresight Analytics)

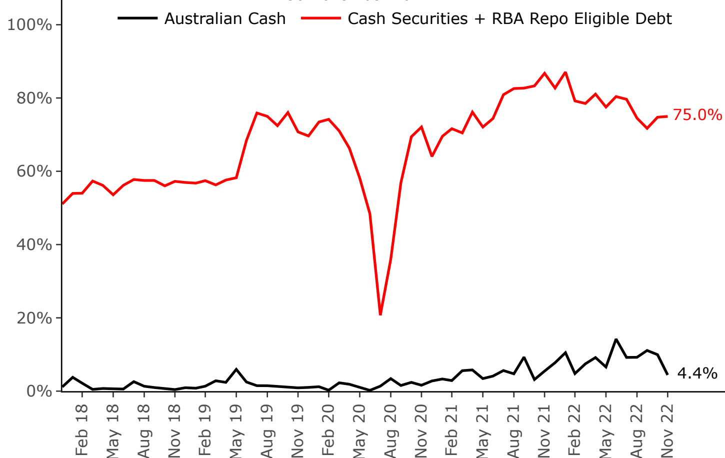


COOLABAH CAPITAL INVESTMENTS™
THE INTELLECTUAL EDGE: MAKING EVERY BASIS POINT COUNT

Fund: **Smarter Money Long-Short Credit Fund - Direct Investor Class**

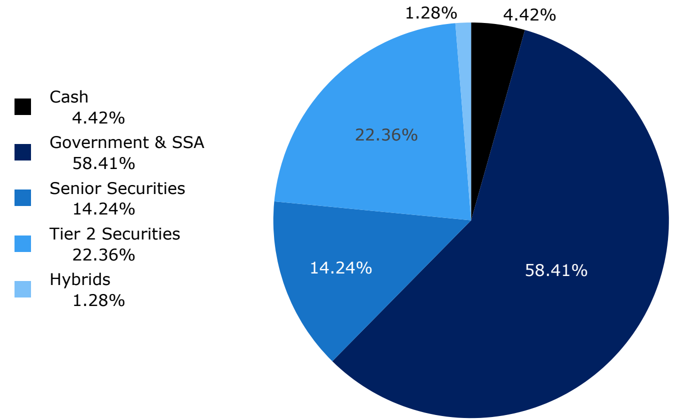
Return/Risk: **4.13% pa gross/2.32% pa net (3.46% pa volatility)**

**Portfolio Weights: Cash + RBA Repo Eligible Debt**
30 November 2022



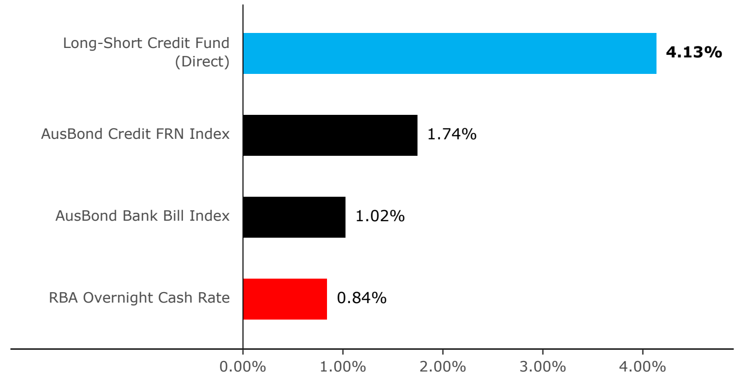

Data Source: Coolabah Capital Investments

**Long Short Credit Fund Portfolio Composition (GAV)**
(Gross Levered Statistics) - 30 November 2022




Data Source: Coolabah Capital Investments

**Long Short Credit Fund Returns (Gross) vs Comparisons**
Annualized Total Returns Since Inception in September 2017 to November 2022




Data Source: RBA, Bloomberg, Mainstream, Coolabah Capital Investments

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**The since inception gross (net) return of 4.13% pa gross (2.32% pa net)** is the total annual return earned by the fund since Sep. 2017, including interest income and movements in the price of the bond portfolio after all fund fees (assuming net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement). The net return quoted applies to the Smarter Money Long-Short Credit Fund - Direct Investor Class, with quarterly distributions reinvested. Each investor's return will vary depending upon their own investment date and any top-ups and withdrawals they make. **The annualised volatility estimate of 3.46% pa** is based on the standard deviation of net daily returns since inception, which are then annualised, attributable to the Smarter Money Long-Short Credit Fund - Direct Investor Class.

| Portfolio Managers | Christopher Joye, Ashley Kabel, Dr Stephen Parker, Dr Nick Campregher (Coolabah Capital Investments) | | |
|---|---|---|---|
| APIR Code | SLT2562AU | Fund Inception | 31-Aug-17 |
| ISIN | AU60SLT25623 | Distributions | Quarterly |
| Morningstar Ticker | 41597 | Unit Pricing | Daily (earnings accrue daily) |
| Asset-Class | Alternatives/Hedge Funds | Min. Investment | $1,000 |
| Target Return | Net 4.0%-6.0% pa over RBA cash rate | Withdrawals | Daily Requests (funds normally in 3 days) |
| Investment Manager | Coolabah Capital Investments (Retail) | Buy/Sell Spread | 0.00%/0.05% |
| Responsible Entity | Equity Trustees | Mgt. & Admin Fee | 1.00% pa |
| Custodian | Mainstream Fund Services | Perf. Fee | 20.5% of returns over RBA cash rate + 1.00% pa |

Signatory of: PRI Principles for Responsible Investment

RECOMMENDED ATCHISON CONSULTANTS

ALPHA MANAGER 2019 Christopher Joye

SUPERIOR MORE COMPLEX Foresight Analytics

MSCI ESG RATINGS A
CCC B BB BBB A AA AAA
Asset weighted average rating

**Portfolio commentary: The zero-duration and daily liquidity Long-Short Credit Fund (LSCF) ended November with a yield to call/maturity of 10.39% (assuming current funding costs), a weighted-average credit rating of AA-, and a portfolio weighted average MSCI ESG rating of A. In November, LSCF returned 3.13% gross (3.05% net), outperforming the RBA Overnight Cash Rate (0.23%), the AusBond Bank Bill Index (0.25%), and the AusBond Credit FRN Index (0.43%).**

**Since the inception of LSCF 5.2 years ago in September 2017, it has returned 4.13% pa gross (2.32% pa net), outperforming the RBA Overnight Cash Rate (0.84% pa), the AusBond Bank Bill Index (1.02% pa), and the AusBond Credit FRN Index (1.74% pa).** While LSCF's return volatility since inception has been low at around 3.46% pa (measured using daily returns), as a daily liquidity product with assets that are marked-to-market using executable prices, volatility does exist. This contrasts with illiquid credit (eg, loans and high yield bonds) wherein assets that have very high risk can appear to have remarkably low volatility, which is, in fact, just a mirage explained by the inability to properly value these assets using executable prices.

**Strategy commentary:** After a month when credit spreads idiosyncratically jumped in October, there was classic — and universally very strong — mean-reversion in November, as we had flagged was likely. This generated exceptionally large returns across all Coolabah's portfolios.

**Spreads Compress, but Remain Cheap**

After peaking at 115 basis points (bps) over the quarterly bank bill swap rate (BBSW), AA- rated, 5-year major bank senior bond spreads finished November at 103pbs, still well wide of their post-2013 average level of 79bps. (Note we measure and track these spreads using our constant maturity indices.)

Along similar lines, the major banks' BBB+ rated, 5-year Tier 2 bond spreads hit an intra-month peak of circa 280bps over BBSW yet finished the month much tighter at 245bps. This compares to the average 5-year Tier 2 spread for the majors at around 189bps. The Tier 2 market was buffeted by some communications from APRA, which we will return to later.

One notch further down the capital stack, BBB- rated, 5-year major bank hybrids listed on the ASX rallied hard with their spreads compressing from 310bps over BBSW to just 278bps. This is materially below the post-2013 average spread of 346bps.

As a result of the outperformance of ASX-listed hybrids, they have come to look somewhat dear compared to the banks' Tier 2 bonds. Historically, 5-year major bank hybrids have paid about 1.8-1.9 times the spread that Tier 2 offers. Today that multiple has plunged to just 1.1 times, which is an all-time low.

In the much safer AAA and AA rated State government bond market, 10-year NSW spreads over Commonwealth bonds crunched in from circa 86bps at their highs in late October (noticeably above even the 60-65bps average levels in March 2020) to 69bps by the end of November, which is still miles above their long-term average of 33bps. In May 2021, NSW spreads got to as low as 15bps.

In summary, credit spreads look very wide (or cheap) in the bank senior, bank Tier 2 and State government bond markets. We are much more neutral bank hybrids. But all these bonds are being boosted by a tremendous increase in the 3-month bank bill swap rate, which has leapt from around 0% last year to 3.1% pa today.

Consider a BBB+ rated, 5-year CBA Tier 2 bond: in 2021, the total running yield would have been about 1.3% pa (or 125bps over a BBSW rate near zero); this year the same bond has paid 5.9% pa on a floating-rate basis. The fixed-rate version of the bond has offered interest rates as high as 6.9% pa.

In our zero duration portfolios, returns for the RBA cash + 1% and RBA cash + 1.5% strategies were in the order of 70bps in the month, the best result since April 2020. In our long/short credit strategy, returns were likewise the best we have recorded since April 2020 at circa 307bps for the month.

**Strategy commentary cont'd:** Another interesting development in November was a sharp reduction in government bond yields and terminal cash rates as markets paired-back some previously crazy forecasts for the RBA's rate. In June and October, bond markets were pricing the RBA lifting its cash rate to as high as 4.6%. In November, this projection was pulled-back almost 100bps to just 3.7%.

Of course, the current RBA cash rate is 2.85%, with the market expecting the RBA to lift it to 3.1% at its December board meeting. If the RBA does not surprise the market with a pause, we think the RBA will consider pausing soon. On this basis, market pricing for a 3.7% terminal RBA cash rate still looks too high.

This has flowed through to long-term government bond yields. In Australia, 10-year Aussie government bond yields peaked around 4.3% in June and were still trading at 4.2% in October. These yields fell sharply in November down to circa 3.53%, which is a trend that has continued in early December.

This triggered a corresponding rally in fixed-rate bonds with the AusBond Composite Bond Index increasing 1.55% in November. Our Active Composite Bond Strategy outperformed, delivering 2.59% on the month.

The catalyst for this rally in risk-free rates has been the fairly synchronised pivot by global central banks to slow-down the pace of their record hiking cycles. This has been rationalised by clear deterioration in the global macro data as interest rate hikes start to bite and unambiguous evidence that core inflation in the US is rolling over.

Before we consider the Australian macro context, let us return to bond market developments. In November there were a flurry of attractive new issues that priced with handsome concessions that Coolabah committed capital to, including:

- Westpac came to market with AA- rated, 3-year and 5-year senior bond issues that paid 95bps and 123ps over BBSW, respectively. These bonds came in floating and fixed-rate formats (we bought both). The 3-year and 5-year fixed interest rates were 4.99% and 5.38% pa;
- NAB followed-suit with identical AA- rated, 3-year and 5-year bonds that paid a similar 92bps and 120bps over BBSW. The 3-year and 5-year fixed interest rates were 4.67% and 5.01% pa;
- ING and Bendigo also hit the market with cheap AAA rated, 3-year covered bond issues that we bought; and
- In US dollars, we picked-up ANZ's AA- rated, 3-year senior bond, which paid 5.1% pa, and its BBB+ 10-year Tier 2 bond, which paid 6.7% pa.

**APRA on AT1 Hybrids/Tier 2**

As noted above, APRA communicated to banks and insurers in November that when seeking permission to repay regulatory capital securities, including Additional Tier 1 capital hybrids and Tier 2 capital bonds, they should ensure they comply with a regulatory standard called APS 111.

Under APS 111, if a bank/insurer wishes to replace an existing AT1 hybrid or Tier 2 bond with a new security that is more expensive for the bank/insurer, they need to explain to APRA to "economic and prudential rationale" for this decision.

It is our belief that two institutions, AMP and Challenger, sought repayment approval on their Tier 2 bonds without providing APRA with the required "economic and prudential rationale". And there was a large differential in the price of the old and new securities, specifically 180bps vs 465bps and 210bps vs 355bps.

Locally and globally banks and insurers replace existing AT1 hybrids/Tier 2 bonds with new securities that are more expensive on a regular basis precisely because there is a robust economic and prudential rationale to do so.

**Strategy commentary cont'd:** Striking examples in Australia include CBA's Perls III hybrid that was issued at 105bps over BBSW and replaced by Perls VIII at 520bps over BBSW. APRA also subsequently allowed both AMP and Challenger to repay their Tier 2s notwithstanding the large cost differential.

The are many obvious explanations as to why this is rational for issuers. First, if a bank or insurer does not call/repay their AT1 hybrids, they normally convert into ordinary shares after two years. The cost of equity is much higher than the cost of AT1 hybrids or Tier 2 bonds. It is economically rational, therefore, to repay existing hybrids and replace them with new securities.

If Tier 2 bonds are not called after 5 years, they automatically lose their contribution to the bank/insurer's Tier 2 regulatory capital ratio at a rate of 20% each year such that they contribute nothing after 5 years (most Tier 2 typically has a hard repayment maturity at year 10, 12, or 15).

This lost Tier 2 capital must be replaced, requiring the bank/insurer to issue new equity, AT1 hybrids, or Tier 2 in its stead. Since non-calls of Tier 2 are globally rare for very large and strong banks, they are normally regarded as a potential signal of liquidity/solvency issues.

Any bank/insurer that failed to call their Tier 2 on the first available date would be immediately punished by a very large increase in their cost of capital. It is entirely possible that they would not be able to access the required Tier 2 at all after a non-call event, forcing them to issue much more expensive equity and/or AT1 hybrid securities.

Once again, it is logical for prudent banks/insurers' to minimise their long-term cost of capital (rather than any individual transaction) by repaying AT1 hybrids and Tier 2 in a predictable fashion.

This is not to say that non-calls do not happen. There have been several cases of full write-offs and bail-ins of AT1 and Tier 2 capital overseas since 2007 by very weak institutions. Here in Australia, Genworth missed a call date on a Tier 2 bond in 2020 for a short period, as did Challenger in the case of one of its AT1 hybrid. Challenger was subsequently hammered by investors with a much higher cost of capital on its next Tier 2 issue, which priced at 355bps over BBSW (vs 210bps for its preceding issue).

**Aussie Macro Market**

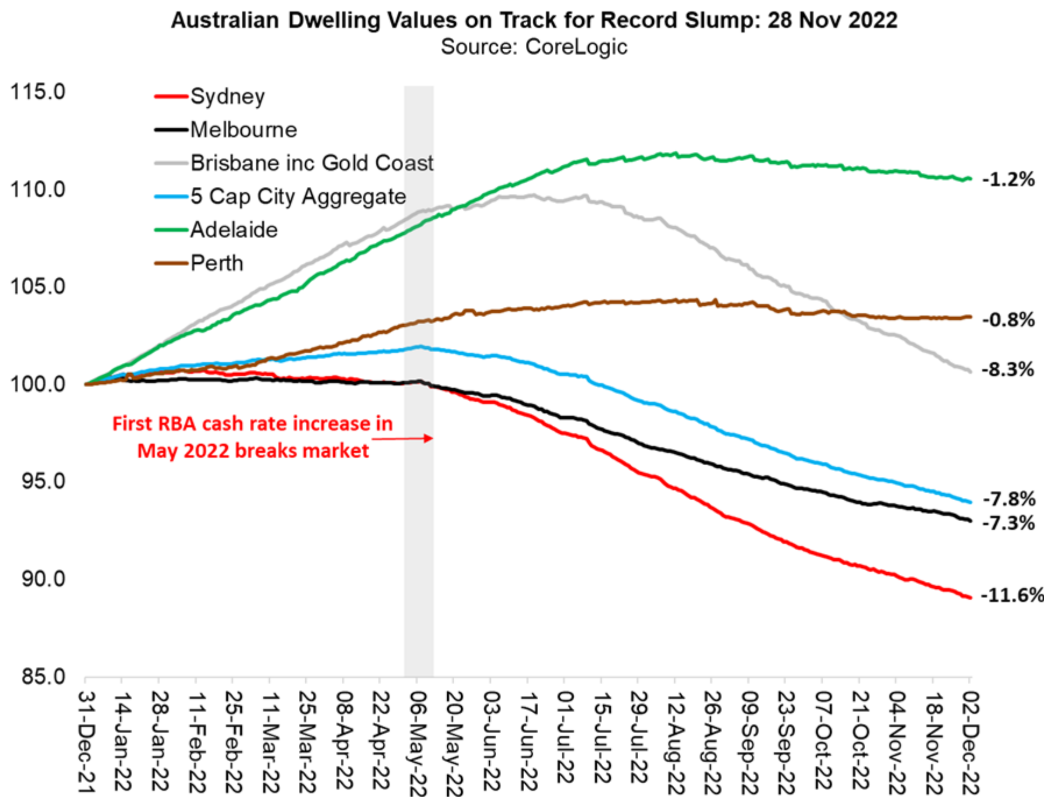
Let us turn now to local macro considerations. Contrary to the "hopeium" out there, there is currently zero evidence that the great Aussie housing crash is bottoming out. The most constructive thing we can say is that house prices are falling incredibly quickly, albeit at a slightly slower pace than what was recorded a few months ago.

November was yet another incredibly weak month with CoreLogic's 8 capital city index shrinking by a hefty 1.1%. While this was identical to the rate of decline recorded in the prior month of October, it was not as savage as the 1.6% loss registered in August.

Across the nation, the unprecedented correction in house prices is playing out at very different speeds: decelerating in some places while accelerating in others.

Ground zero right now is greater Brisbane where dwelling values are falling at a never-before-seen 2% monthly rate, which has accelerated over the last five months. Since their peak in early July, Brisbane home values have lost about 8.5% in total. In 40 years of data collected by CoreLogic, the consecutive 2% monthly drawdowns in October and November were the worst months ever witnessed.

**Strategy commentary cont'd:**




A similar theme is playing out in Hobart where the monthly rate of dwelling price declines has accelerated from a 0.2% loss in June to a chunky 2% decline in November.

If you want to spin a positive story, you could highlight that the house price falls have been slowing in Sydney and Melbourne from a monthly peak of 2.2% and 1.5%, respectively, in July to 1.3% and 0.8% in November.

But the harsh reality is that dwelling values in Australia's two largest cities are still evaporating at an extraordinarily rapid clip. Based on the last two months of data to 2 December, Sydney home values are falling at a 14.1% annual rate while Melbourne prices have been melting at a 9.6% annual rate.

It is also telling that the rate of house price losses in both October and November was identical across Australia's three largest cities: Sydney (down 1.3% each month), Melbourne (down 0.8% a month), and Brisbane (off a shocking 2.0% per month). This implies that losses are now accruing at a more stable rate.

Unfortunately, there is more bad news to come. Unless the Reserve Bank of Australia quickly comes to its senses, it is barrelling towards yet another interest rate increase in December, which would mean borrowers have been slugged with a record 300 basis points of rate rises since May.

To be clear, there is a compelling case the RBA should pause to take stock of the damage it is inflicting on the economy. It claims it wants to be data dependent, and is not on a predetermined course, but we have seen scant evidence that the RBA is being anything other than deterministic based on its rubbery forecasts.

The latest monthly inflation data was a massive downside surprise, printing at 6.9% for the year to October compared to the 7.6% expected by hawkish economists. Retail sales contracted by 0.2% in October relative to the 0.5% again optimistically forecast by analysts. Outside of spending on food, sales were even weaker, dropping by 0.6% in the month.

What makes this even more significant is that this data is expressed in "nominal" terms, which means it is boosted by the current elevated rate of inflation. In real or inflation-adjusted terms, retail spending would have fallen even further.

**Strategy commentary cont'd:** This should come as no surprise to our readers, because we have repeatedly stressed that consumer confidence is worse than it was during the global financial crisis. Once lofty business confidence has also more recently plummeted.

The latest composite PMI suggests the private economy actually contracted over November. While lagging wages, inflation and jobs data are still firm, they will follow suit in time.

CBA economist Gareth Aird argues that “there is a strong case to leave the cash rate on hold in December given the RBA has already delivered an incredible 275 basis points of tightening over just seven meetings (six months)”.

“It takes time for this tightening to impact the demand for goods and services and by extension prices,” Aird continues.

“A further 25 basis point hike in December would mean an unprecedented 300 basis points of rate hikes over just seven months. The RBA is still flying blind to a degree given the last few rate hikes have not yet hit home borrowers from a cash flow perspective (at CBA there is on average a three month lag between RBA rate hikes and when a borrower on a minimum mortgage repayment schedule experiences an increase in their mortgage payment).”

The RBA estimates that around 23% of all Aussie home loans – worth almost $500 billion worth – are fixed rate and will switch to variable rate by the end of 2023.

“Based on current market pricing for the cash rate and assuming full pass-through to variable mortgage rates, most fixed-rate borrowers with loans expiring in 2023 will face discrete increases in their interest rates of 3–4 percentage points when they roll over to variable rates, depending on their current rate and the timing of their fixed loan term expiry,” the RBA warns.

Martin Place has further revealed that if its cash rate were to increase by 3.5 percentage points in total, “almost 60% of borrowers with fixed-rate loans would face an increase in their minimum payments of at least 40% when they expire”.

This is an interest rate shock that was never meant to happen. Before October 2021, banks were only required by the Australian Prudential Regulation Authority to apply a mortgage repayment test that involved using an interest rate that was just 2.5 percentage points above the actual product rate. The RBA has already increased its target cash rate by more than this (ie, 2.85 percentage points). Market pricing expects the totality of the RBA’s interest rate increases to reach 3.7 percentage points.

In October 2021, APRA prudently front-ran the RBA, and jacked up the minimum repayment test buffer for banks to 3 percentage points. (Most non-bank lenders still use a miserly 2.5 percentage point buffer.) This will, however, prove to be inadequate to cope with the circa 350-400 basis point interest rate shock that the RBA will inflict on borrowers.

Put differently, there will be many borrowers who took out ultra-cheap home loans in 2020 and 2021 on the presumption that the RBA would not lift rates until after 2024 who will now face mortgage rates that are 40% more than the maximum their lender thought they would ever have to service during their lifetimes (ie, via APRA’s stress test).

Most of the fixed-rate loans taken out in 2020 and 2021 were struck at mortgage rates of between 1.75 and 2.25%. As almost 1-in-4 Aussie home loans have their fixed rates switch to variable rate by the end of 2023, the interest rates paid by these borrowers will more than double to 5-6%.

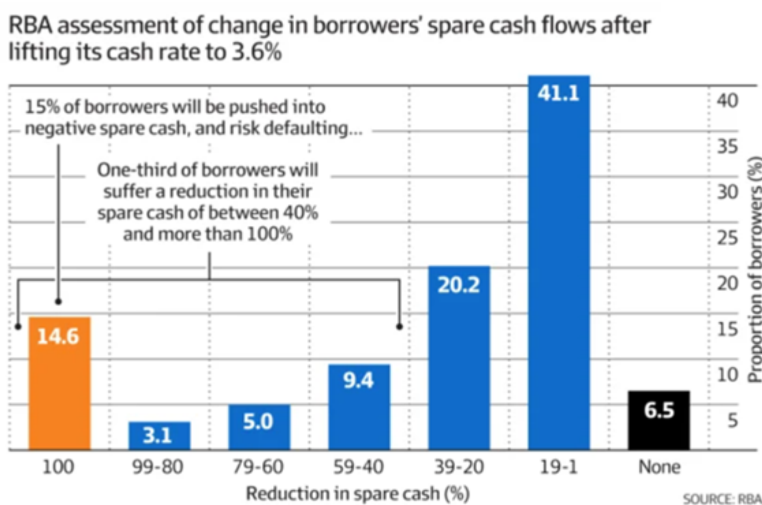
In contrast to most other nations where most loans are long-term fixed-rate products, the pass-through of monetary policy in Australia directly hits almost every single borrower in the short term. This is also why the RBA’s rate changes have a much bigger and more immediate impact on our housing market compared to peers overseas.

One key question that has been weighing on the RBA is how big a deal this record rise in the cost of capital will be for consumers’ free cash flow (or their disposable income). This is crucial for the outlook given that consumer spending accounts for about 50% of total economic growth.

**Strategy commentary cont'd:** Using the RBA's data on residential mortgage-backed securities, it finds that more than 52% of all borrowers will see their "spare cash" decline by between 20% and more than 100%, assuming its target cash rate climbs to 3.6%.

Spare cash is defined by the RBA as the income the borrower has left over after meeting mortgage repayments and "essential living expenses".

A staggering 15% of all borrowers will have their spare cash turn negative in the RBA's base case. That means they are at a very serious risk of defaulting on their loan repayments. A total of 23% of all borrowers – or more than one in five – will see their spare cash shrink by between 60% and more than 100%. Almost one-third of borrowers will have their free cash reduced by between 40% and over 100%.




So right now, there is really no good news on house prices. The pain is set to continue for many more months to come unless the RBA swings 180 degrees and starts cutting interest rates, which nobody expects in the very near-term.

In Sydney, home values have now fallen almost 12% peak-to-trough. Across the 5 largest cities, the losses have accumulated to about 8%. Brisbane prices are down roughly 8.5% (and falling at 2% each month). Melbourne properties are off 7.5%.

In October 2021, we argued that national home values would correct by 15-25% after the RBA commenced raising rates. At the time, no mainstream analysts were forecasting material price falls. The previous record for Aussie house price losses was 10-11% between 2017 and 2019, which we should surpass in around March.

Importantly, one should not necessarily expect a super-strong bounce in prices once the RBA finishes its dirty work. It will really depend on when it cuts rates, and by how much. If it does not reduce rates, prices will not appreciate until purchasing power dictates they should. And with no interest rate relief, purchasing power will be driven by income growth, which tends to be a slowly moving beast...

Don't forget to listen to Coolabah Capital's popular Complexity Premia podcast. You can listen on your favourite podcast app, or you can find it on Apple Podcasts or Podbean.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